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RR RUEHBZ RUEHDU RUEHJO RUEHMR RUEHRN
DE RUEHLS #0080/01 0361005
ZNR UUUUU ZZH
R 051005Z FEB 09
FM AMEMBASSY LUSAKA
TO RUEHC/SECSTATE WASHDC 6699
INFO RUCNSAD/SOUTHERN AF DEVELOPMENT COMMUNITY COLLECTIVE
RUCPDOC/DEPT OF COMMERCE WASHDC

UNCLAS SECTION 01 OF 03 LUSAKA 000080

SENSITIVE
SIPDIS

E.O. 12958: N/A
TAGS: EMIN ECON EFIN ZA
SUBJECT: MINING SECTOR MALAISE WORSENS

¶1. (SBU) Summary. Zambia's mining sector has been hit hard by the fall in commodity prices induced by the global economic recession. Responding to pressure from the private sector, the Zambian Government (GRZ) has announced its intention to withdraw its windfall tax on mining revenue as well as make several other small concessions to the mining industry. The gesture is mostly symbolic, however, as the windfall taxes do not apply at current price levels, with copper prices currently hovering around USD 1.50/lb. Although appreciative of this development, mining companies remain deeply concerned about the viability of their operations in Zambia, given high production and transportation costs, inadequate local smelting capacity, and the still onerous tax regime. Although troubled by rising unemployment, Mines Minister Maxwell Mwale expressed confidence that the sector will absorb these shocks and maintain profitability. He affirmed that the Ministry has no intention of nationalizing the closed mines. End Summary.

Government Withdraws Windfall Tax

¶2. (SBU) On January 30, Finance Minister Situmbeko Musokotwane announced to parliament that the GRZ intends to withdraw its windfall tax on mining revenues. The windfall tax had been part of a new minerals tax regime that included higher corporate tax and mineral royalty rates. The taxes had been the source of much contention since their unilateral introduction in early 2008, with mining companies claiming that the new taxes abrogated their (still treated as secret) development agreements with the GRZ. The GRZ's response (supported by the World Bank and several bilateral donors) had been -- and continues to be -- that the terms of the development agreements, which the GRZ had signed to lure investment during privatization, had been too generous and did not significantly compensate Zambia for its natural resources. According to an industry analyst, the Zambian Chamber of Mines had been lobbying for months against the windfall tax and had seized the opportunity of lower prices, mining closures and downsizing, and a sympathetic Finance Minister to push for its revocation. The Director of the Chamber of Mines Nathan Chishimba claimed to emboff that the combination of the windfall tax on revenue (vice profits) plus variable profit, corporate, and royalty taxes had the potential to cost a mining company USD 1.05 for every USD 1 of revenue, had it been implemented.

¶3. (U) The windfall tax withdrawal will cost the government nothing at present, given that the taxes do not take affect until copper prices rise above USD 2.50/lb. The concession, however, marks a symbolic relaxation of the GRZ's mining reforms and a recognition of the need to conciliate with its mining companies. During his presentation to parliament, Finance Minister Musokotwane also announced that the GRZ would allow companies to depreciate their capital investments by 100 percent in the first year (rather than by 25 percent per year over a four year period) in order to encourage mining sector investment. To reduce operating costs in the ailing mainstay of the Zambian economy, Musokotwane said the GRZ would cut import taxes on heavy fuel oil (from 30 to 15

percent), allow mining companies to add hedging income to (and presumably deduct hedging losses from) their taxable income, and defer value added tax on copper concentrate imports from the Democratic Republic of Congo, effective February 1st.

¶4. (SBU) Although the private sector welcomed the moves, mining companies remain deeply concerned about their economic prospects, particularly given high production and transportation costs. The managing director of Kansanshi Mining (a company owned by First Quantum Minerals of Canada), told emboff that the new tax structure is still more "onerous" than the terms that the GRZ had offered to most mining companies in their individual development agreements. He also pointed to the 15 percent export levy on copper concentrates, making the export of unprocessed copper a "money-losing proposition" at current copper price levels. Additionally, he noted that existing and near-term smelting capacity in Zambia is less than half of that which is needed. Consequently, mines that produce concentrate in excess of that which the Zambian smelters can treat will either produce less or shut down altogether, he projected.

Mining Closures and Cutbacks

¶5. (SBU) Mines Minister Maxwell Mwale appears to share little of Musokotwane's concern about the impact of the global economic crisis on Zambia's mining sector. In a meeting with the Ambassador on February 2, Mwale acknowledged that mining companies had been hurt by declining commodity prices and that this had sent shockwaves to other segments of the Zambian economy. Mwale, however, said that he believed

mining companies could operate profitably at current world price levels. He also maintained that Zambia had spare smelting capacity. Mwale pointed to petroleum prospecting in Northwestern, Eastern, and Southern Provinces as well as impending uranium production. He speculated that this would be particularly feasible for Equinox's Lumwana Copper Mine, which he said intends to extract uranium mineralization in order to produce uranium oxide ("yellowcake"). (Note: In early January, Lumwana announced the postponement of its uranium treatment plant, due to difficulties securing project financing. Lumwana, however, will continue to stockpile uranium-bearing material for potential processing at a later date. End note.)

¶6. (SBU) Mwale opined that many of Zambia's mining companies had priced their investments according to historically high prices, rather than industry averages, and had been operating inefficiently. He projected that this was particularly true for Luanshya Copper Mines (LCM), a joint venture between Swiss-based International Mineral Resources and Ben Stein Group Resources of Israel, which closed its operations in December 2008. According to Mwale, LCM had been outsourcing much of its operations, which become economically untenable after the fall in metals prices. Mwale opined that LCM's transfer pricing arrangement for smelting services from its affiliate, Chambishi Metals, had been to LCM's disadvantage.

¶7. (U) Mwale expressed regret about the unemployment resulting from LCM's closure, pointing to the ripple effect on mining service providers. He estimated that LCM's closure may result in as many as 6,300 lay offs, consisting of 1,300 LCM employees and perhaps 5,000 contractual laborers, service providers, and suppliers. Closure of the Chambishi Metals smelter and down-sizing at both Kansanshi Mining and Mopani Copper Mines could bring the total number of job losses to about 8,000, Mwale suggested.

GRZ Response

¶8. (SBU) Countering local media reports that the GRZ would take over failing mines, Mwale said that it was the GRZ's role to create an enabling environment for private sector-led

growth. Mwale affirmed that the GRZ does not intend to nationalize LCM, although an almost entirely government-owned holding company, Zambia Consolidated Copper Mines (ZCCM-IH), may operate it until the GRZ finds a suitable investor. Mwale said that he had received expressions of interest from Russian, Chinese, South African, and Middle Eastern companies, but that the GRZ did not want to transfer ownership o the mine until it had resolved questions related to LCM's outstanding liabilities to "domestic sharholders," presumably referring to ZCCM-IH's 15 prcent stake in LCM, which it bought for USD 1.5 illion in 2005. Ambassador urged Mwale to condut an open solicitation for investors rather than ust deal with those who come calling. He said sch an open solicitation should include an honest asessment of LCM's assets and liabilities. (Comment: Mwale seemed interested in such an approach. End Comment.)

¶9. (SBU) In a separate meeting, Chamber of Mines Director Chishimba claimed there was little investment interest in the mine due to enduring investor skittishness since the GRZ's unilateral imposition of the new tax regime in 2008, even though the windfall tax was subsequently revoked.

¶10. (SBU) The Ambassador briefed Mwale of Zambia's qualification for a Millennium Challenge Account Compact, which could entail a major infusion of funding to reduce poverty through economic growth. The Ambassador emphasized the importance of making continual strides on anti-corruption, in order to maintain Compact eligibility, and suggested that the GRZ's eventual participation in the Extractive Industries Transparency Initiative (EITI) would be a useful signal of the GRZ's commitment to integrity and the rule of law. Mwale noted that the GRZ has an EITI committee in place, chaired by the Secretary to the Treasury, and is seeking government and stakeholder approval for its draft work plan. Chishimba said the Chamber of Mines actively supports the EITI but senses the GRZ is only focused on industry obligations for EITI, not its own.

Comment

¶11. (SBU) The true viability of Zambia's mining sector probably lies somewhere between the Mines Ministry's optimism and the private sector's despondency. Mining executives continue to resent the GRZ's unilateral abrogation of development agreements that offered long-term concessions to attract international investors. Although the elimination of the windfall tax may hearten investors, the Zambian Government may have forfeited much of its credibility over

the past year, and the Zambian market may have lost much of its appeal for mining investors, at least at current commodity prices. Although this may not fend off all foreign investment to the mining sector, it may attract a lower-tier of mining companies that have a larger appetite for risk. It may also dampen Zambian economic prospects and delay the mining sector's expansion beyond the global economic recovery.

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